

# **Interpreting Market Signals: Where Should You Invest Today?**

**Southern Conference on Teacher Retirement**

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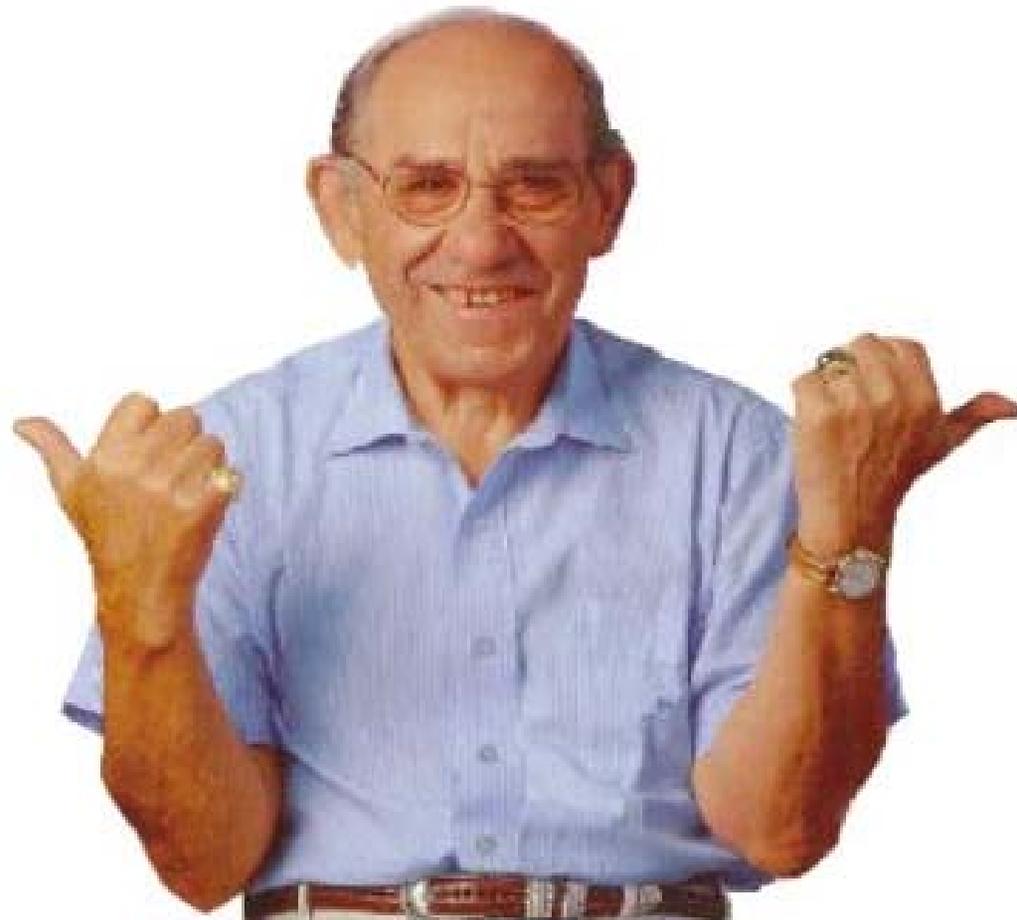
What  
Happened  
in 2004?



Nothing

What Will Happen  
in 2005?

It's deja-vu all  
over again!



# 2005 Base Case Outlook: Where Will the Consensus Be Wrong?

## ◆ Economic and Market Outlook

- Solid (albeit slower) Economic Growth: 3% - 3.5%
- Gradual Increase in Core Inflation: 2% - 2.5%
- Decelerating Profit Growth: 6% - 10%
- Fed Funds Rate: 3.25% - 3.5%
- 10-year Treasury Yield: 5.25%

## ◆ Expected Returns

- Bonds 3-4%
- Stocks 7-9%

# Our Economic Assessment: Positive Overall, With Some Key Risks

## ◆ Positives

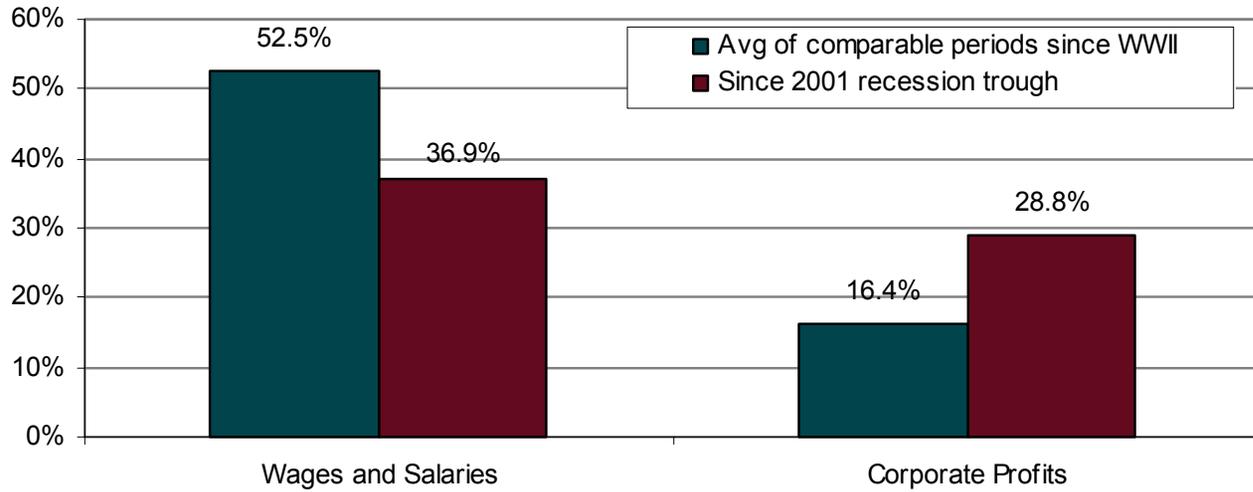
- Broad-based expansion should last through 2006
- Leadership shifts from households to businesses
- Inflation under control

## ◆ Risks

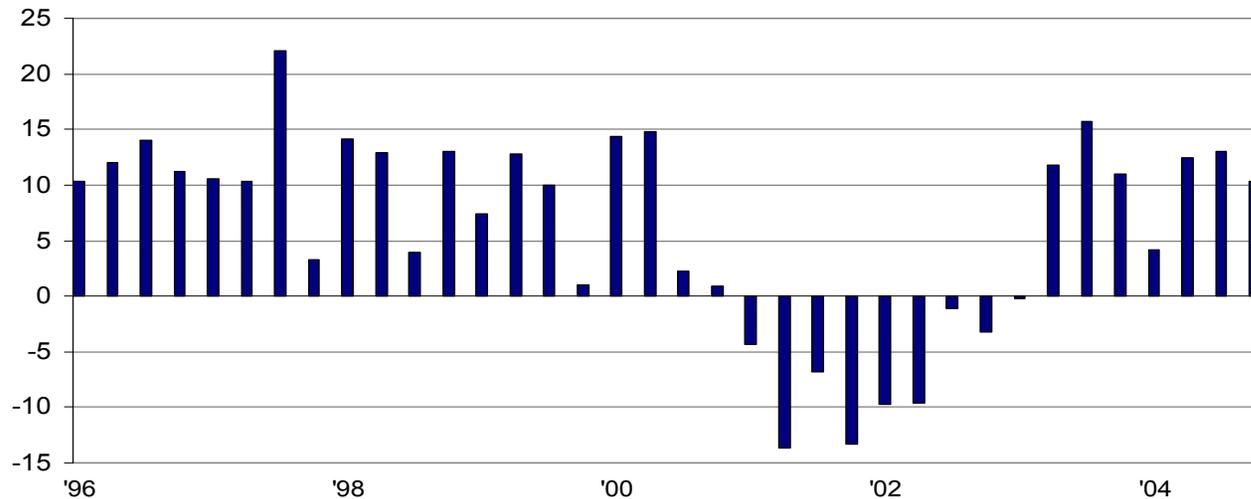
- Fed ends easy money policy
- Oil and commodity prices headed higher?
- Unsustainable U.S. trade deficit

# Corporate Profits and Business Investments Have Improved Significantly

Share of increase in nominal national income from increase in wages & salaries and corporate profits



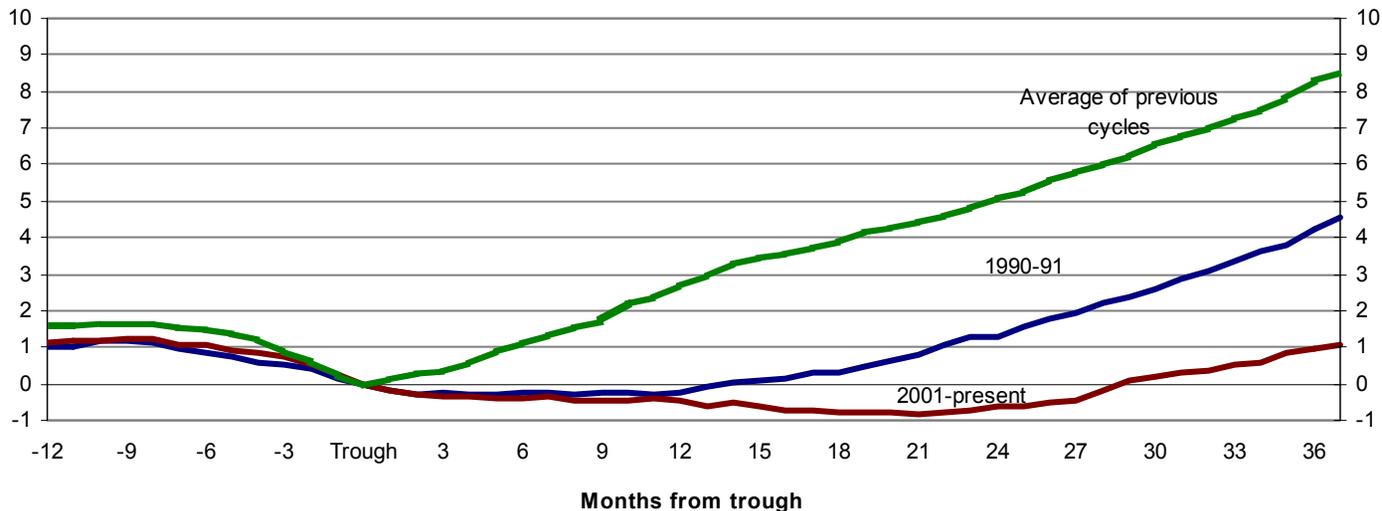
**Nonresidential Business Investment**  
Q/Q Annualized Rate



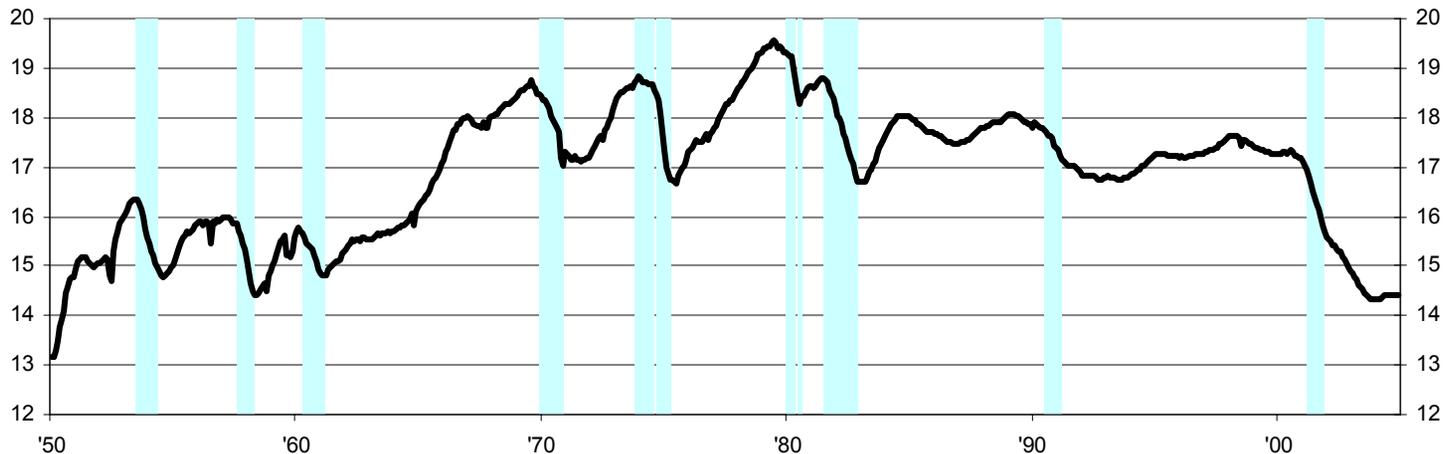
Source: ISI

# Job Growth Has Lagged Previous Expansions, But It's Picking Up

**Payroll Employment**  
(% change from recession trough)



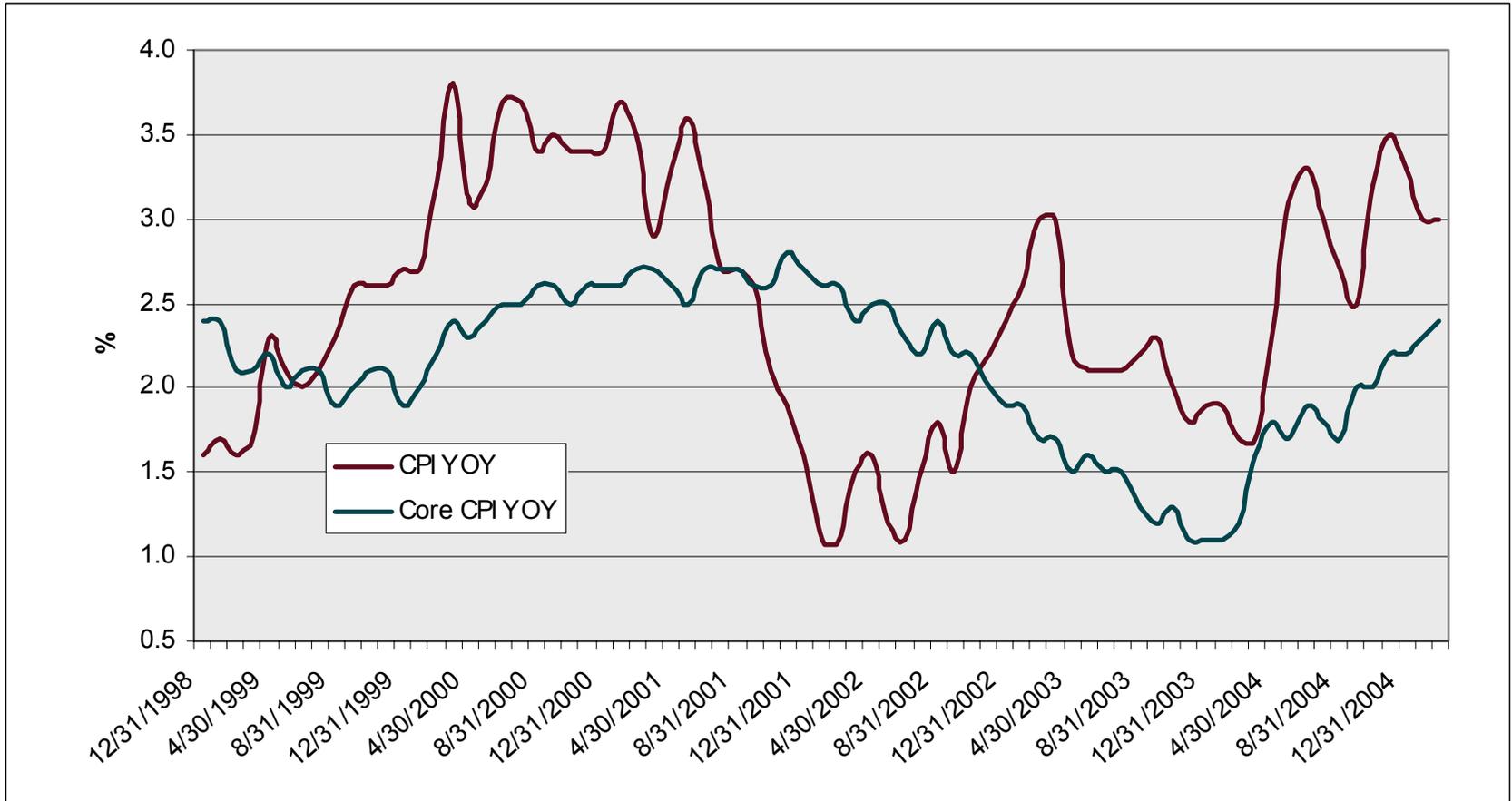
**US Manufacturing Employment Down To Levels Not Seen Since Early '60s**  
(in millions)



Source: ISI

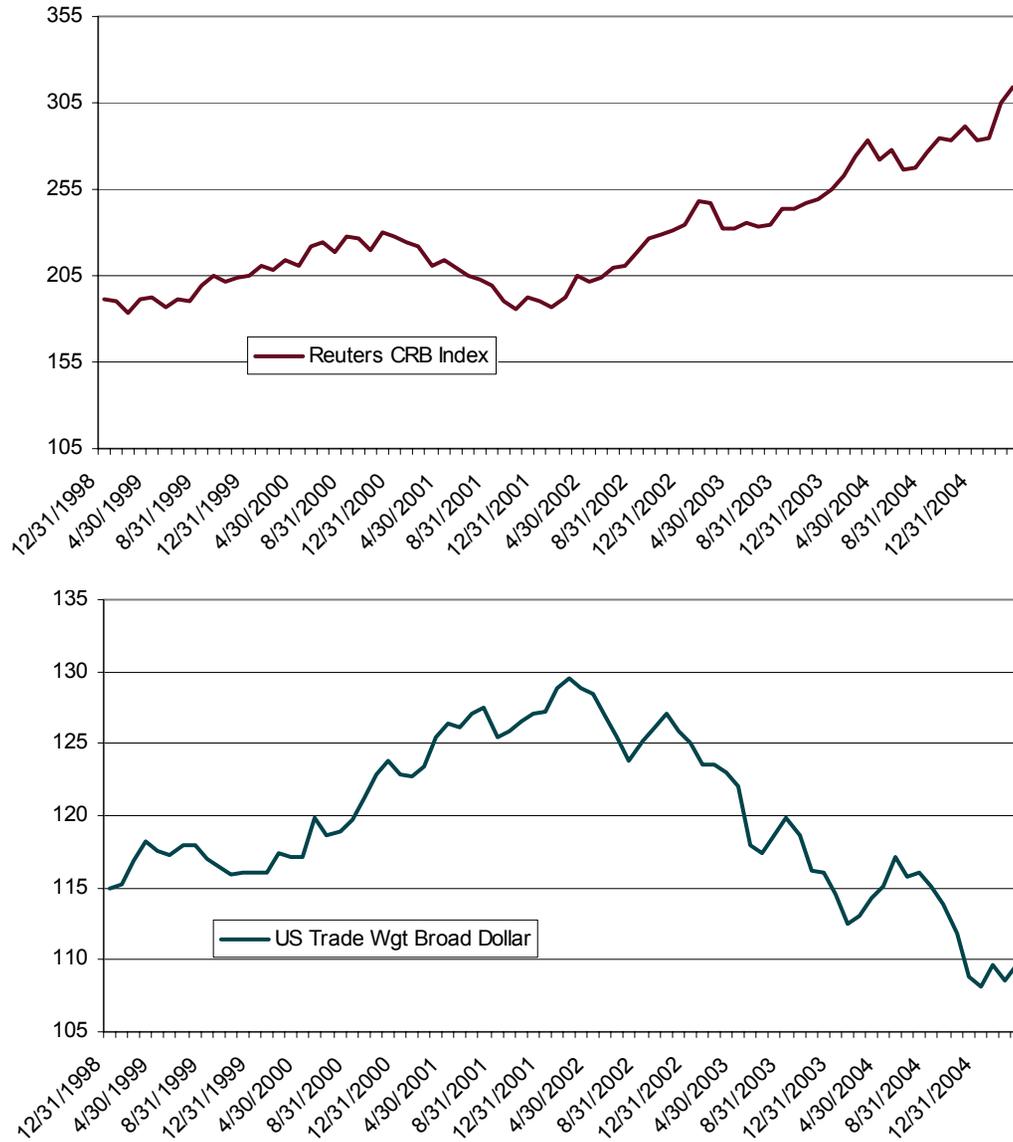
# Inflation is Low, but Edging Higher

## CPI Inflation



Source: Bloomberg

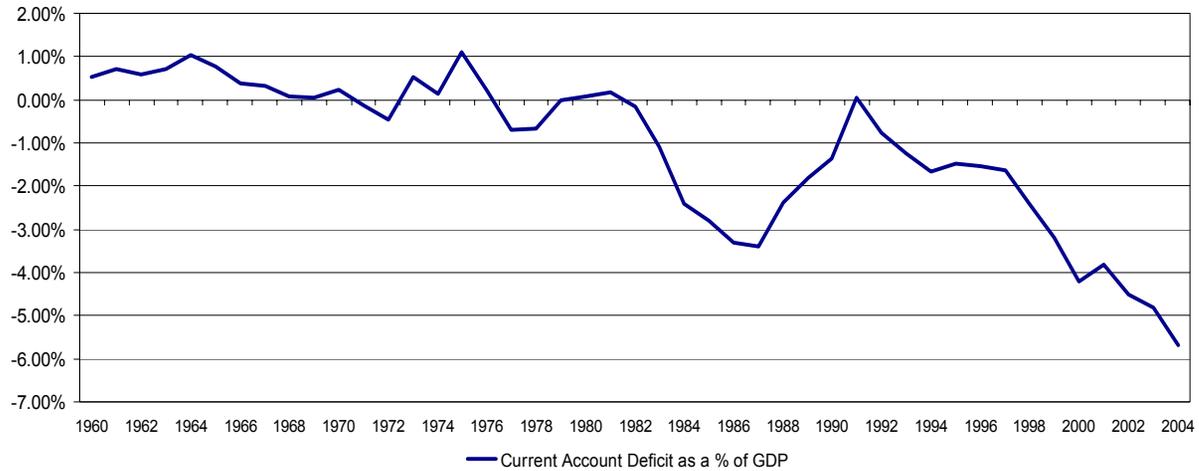
# Do Rising Commodity Prices and a Weaker Dollar Signal Higher Inflation?



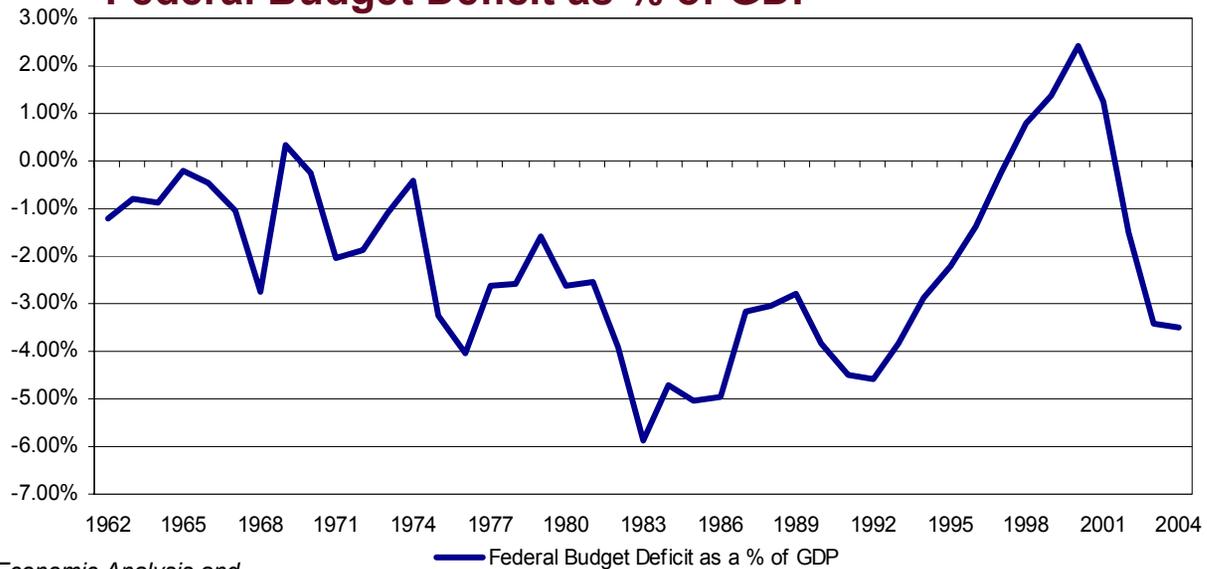
Source: Bloomberg

# “Twin Deficits” Are Back...

## Current Account Deficit as % of GDP\*



## Federal Budget Deficit as % of GDP\*\*



\* Source: Bureau of Economic Analysis and

\*\*Source: Office of Management & Budget

# Do They Spell Trouble?



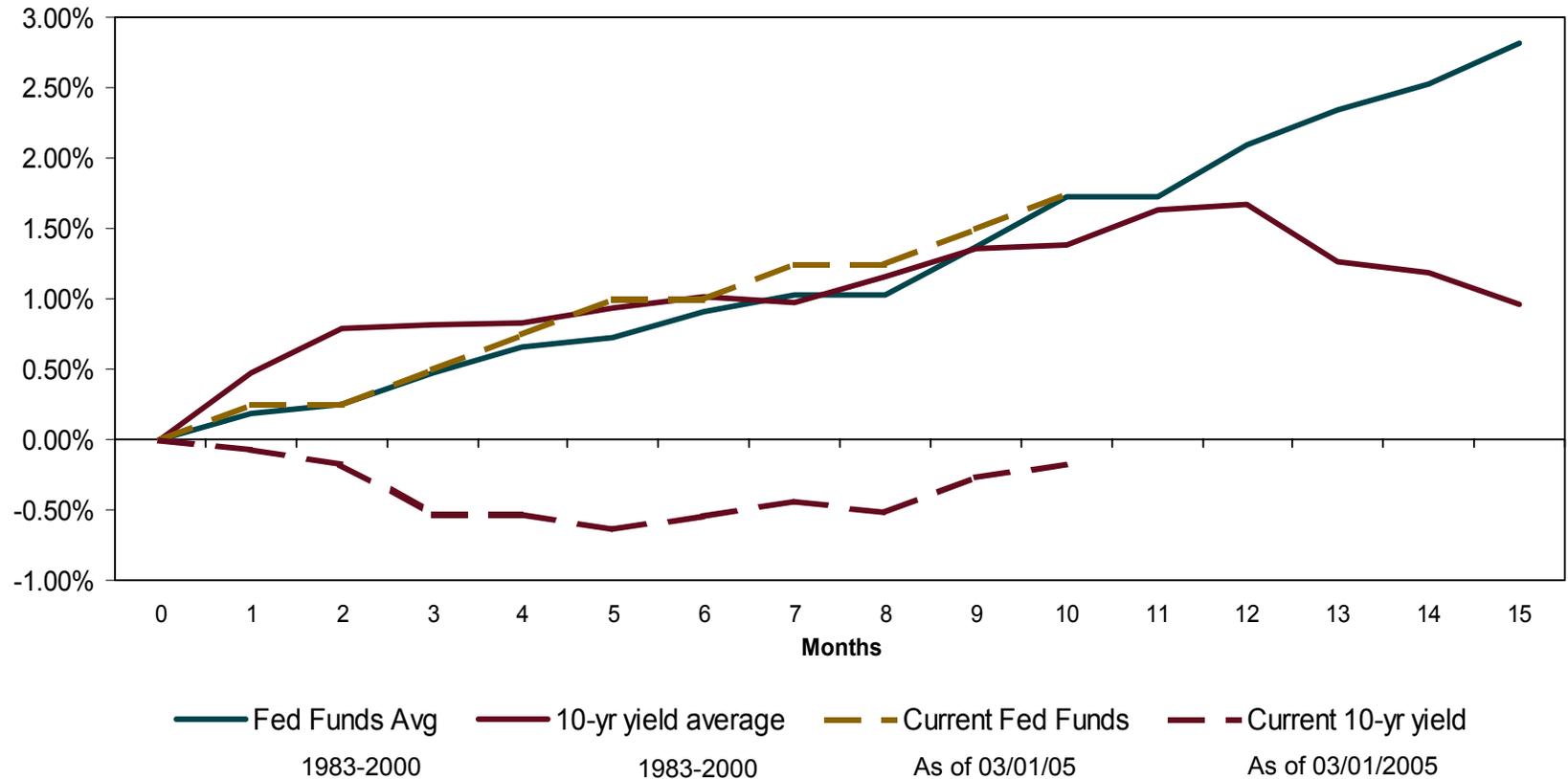
The U.S.  
don't get no  
respect.

What, me worry?



# 2004 Anomaly: Why Have Bond Yields Declined?

## Cumulative Changes in Fed Funds and 10-Year Yield During Major Tightening Cycles



Source: Bloomberg

Past performance is not indicative of future results.

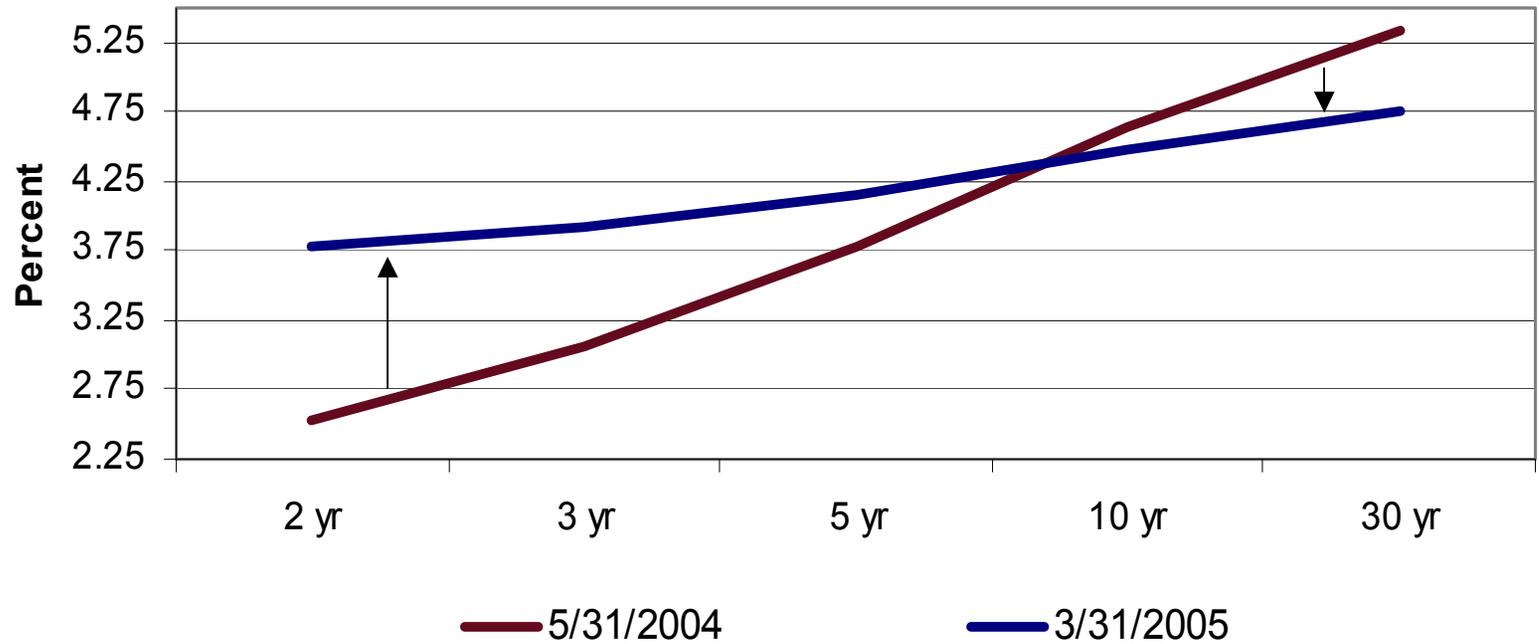
## Alan Greenspan's Answer:

“Rising interest rates have been advertised for long and in so many places that anyone who has not hedged his position by now is obviously desirous of losing money.”



# One Clear Trend: A Flatter Yield Curve

## Treasury Yield Curve



Source: Bloomberg

# Credit Spreads: How Much Narrower Can They Get?

Corporate Spread

High Yield Spread

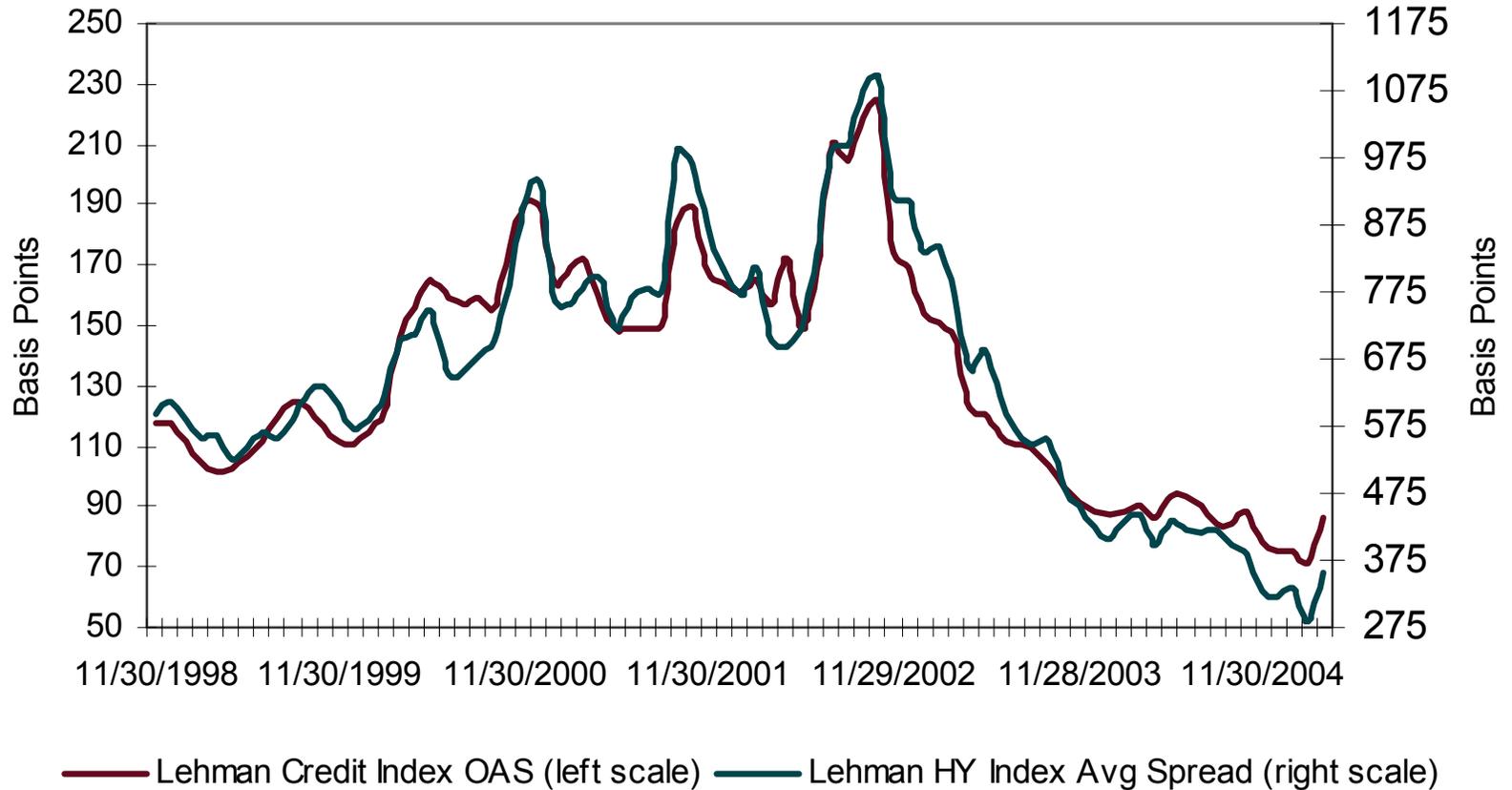


Chart Range: 12/31/1998 – 03/31/05 - Monthly

Source: Bloomberg

Past performance is not indicative of future results.

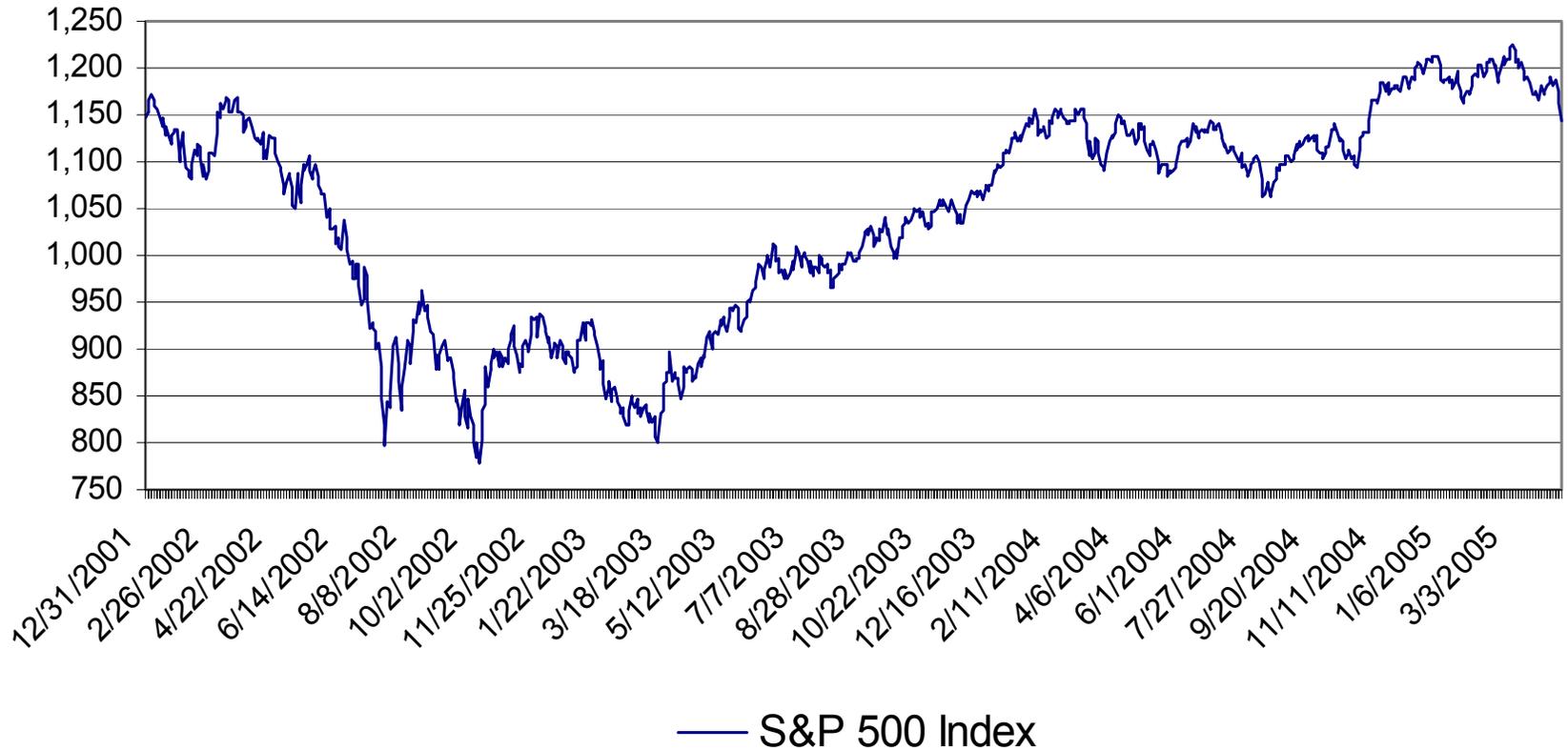
## Positioning Fixed Income Portfolios

- ◆ **Portfolios are defensively positioned – short duration**
- ◆ **Positioning for further flattening of yield curve**
- ◆ **Increase current yield of portfolio without taking excessive credit risk**

## Key Issues for Equity Strategies

- ◆ **Rising interest rates could prompt further multiple contraction.**
- ◆ **A weaker dollar benefits U.S. exporters and multinationals.**
- ◆ **Sustained economic growth should buttress corporate profits.**
- ◆ **Rising oil and commodity prices no longer are benign.**

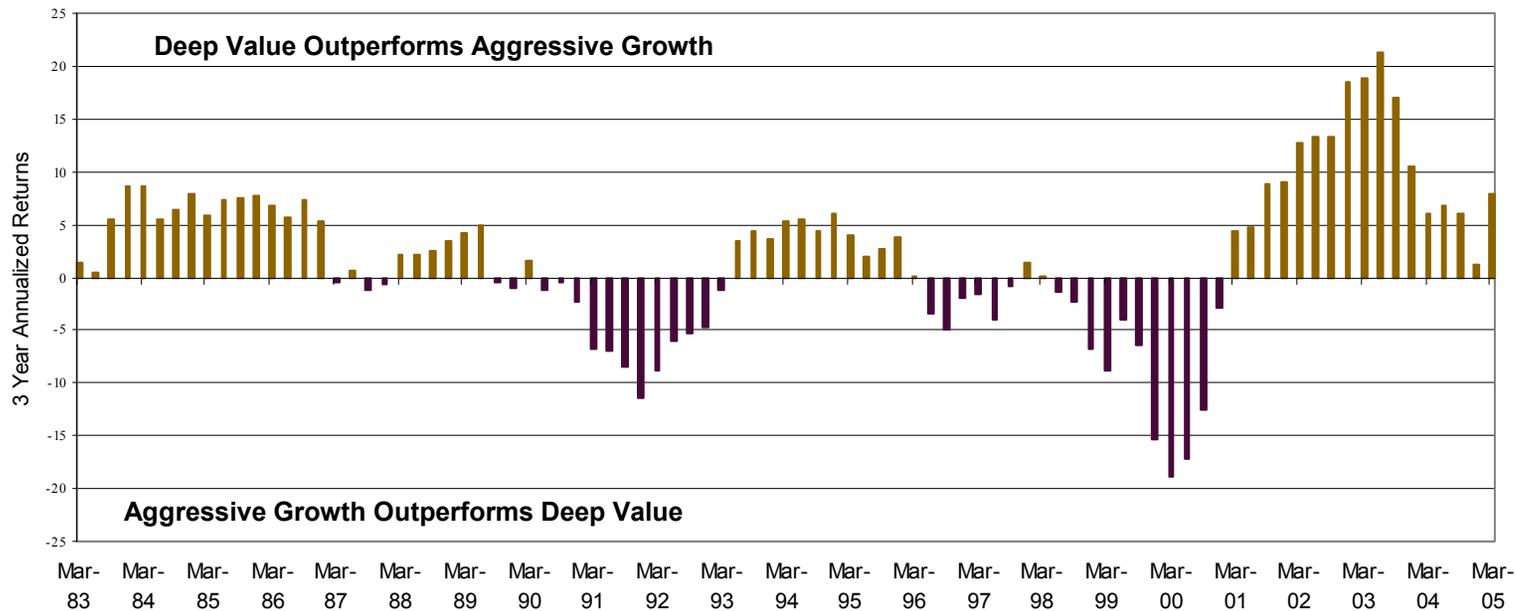
# The Stock Market's Response: Caught in the Middle



Through 04/15/05  
Source: Bloomberg

# When Will the Market Cycle Enter a Growth Phase?

## Russell 1000 Value – Russell 1000 Growth <sup>(1,2)</sup>



- 1) Based on rolling 3-year periods
- 2) Based on the Russell 1000 Value and Growth Indices

Source: Zephyr StyleADVISOR  
 Past performance is not indicative of future results.

- ◆ **Bonds: Stay Defensive as the Fed Raises Interest Rates**
  - Treasury yield curve to continue to flatten
  - Wait for 10-year yield to hit 4.5% - 5.0% before extending
  
- ◆ **US Stocks: Use Sell-offs to Build Positions**
  - The market is reasonably priced
  - Trade up for quality names

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